Economy and Financial Markets
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Central Europe Economics View

Deep recession likely in 2020

- In this report we update our forecasts, taking into account the unprecedented extent of social distancing measures in Poland as well as available data on economic activity in Europe.
- We expect Polish economy to contract by more than 3% in 2020, with biggest hit likely in 2Q, followed by a gradual recovery. Consumption could fall by ~10% QoQ in 2Q.
- In the coming months the number of new unemployed persons will likely rise sharply as firms facing liquidity problems and a drop in demand will try to reduce costs. Unemployment could double, exceeding 10% in the coming months.
- Although the MPC did not signal more rate cuts, we expect the incoming data will change this stance and therefore the base rate will be reduced by additional 50bps to 0.5% in 2Q.
- Taking into account the government's fiscal package (so called *Anti-crisis shield*), the shortfall in tax revenues resulting from recession and the likely deterioration in tax collection, we estimate the fiscal deficit in Poland could reach 7.5% of GDP in 2020.

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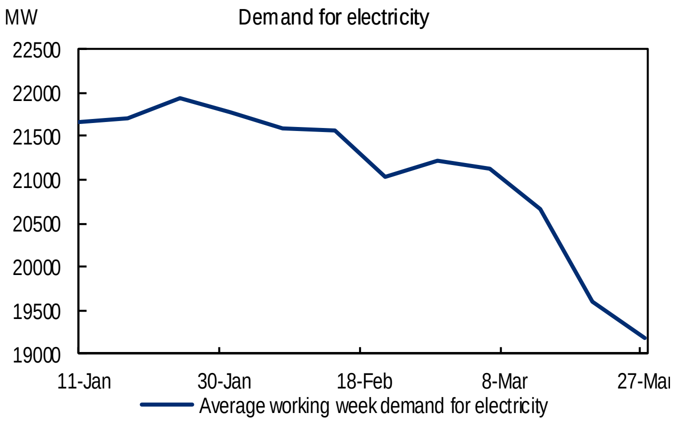
A deep recession likely in 2020

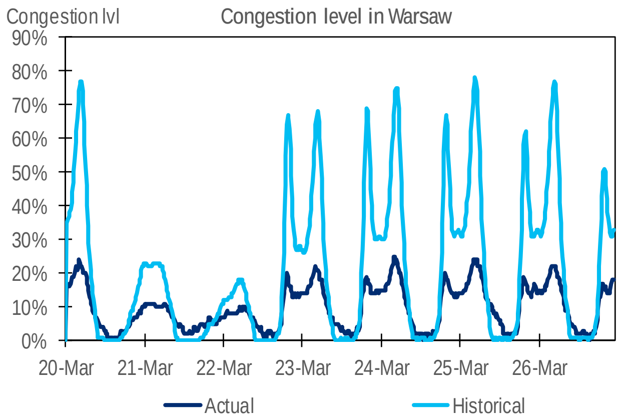
Over last several weeks Poland, along with other Central European countries, introduced a range of social distancing measures. These decisions are likely to have negative impact on economic activity in 1Q and more significantly in 2Q. Already now high frequency indicators, including electricity consumption, trackers of city traffic or motorway traffic are signaling that activity collapsed in the second half of March. By any account the service sector is likely to be hit the most. Although the GUS confidence survey for the services sector was conducted before March 10th and therefore it does not include yet the impact of COVID-19 on activity, the euro area service PMI indices give a flavor of the scale of the shock that may hit Polish service firms.

Figure 1. Electricity consumption in Poland has seen a sharp decline in March (9.3% drop in the last week of March vs. first week of March)



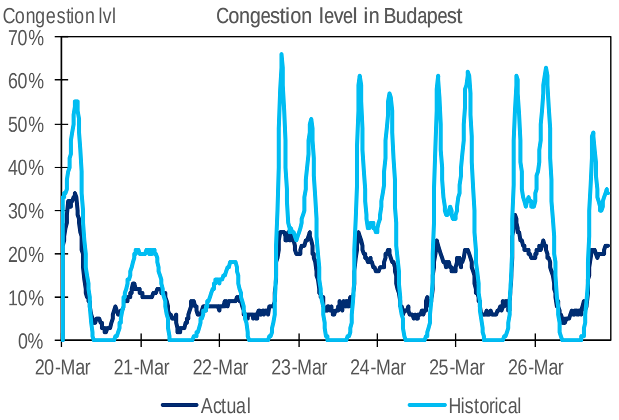
Source: PSE, Citi Handlowy Research

Figure 2. Traffic congestion in Warsaw



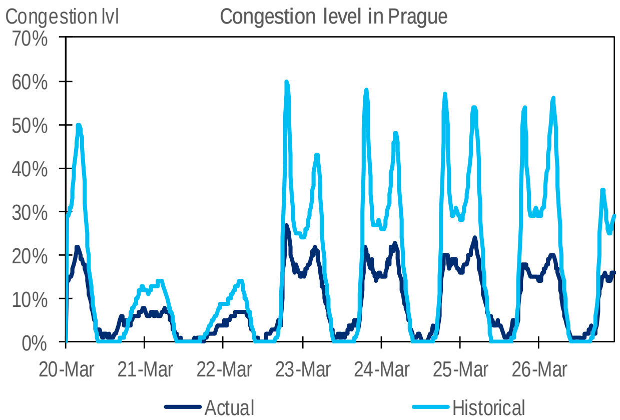
Source: TomTom, Citi Research calculation as of 27 March 2020, 12.55pm

Figure 3. Traffic congestion in Budapest



Source: TomTom, Citi Research calculation as of 27 March 2020, 12.55pm

Figure 4. Traffic congestion in Prague

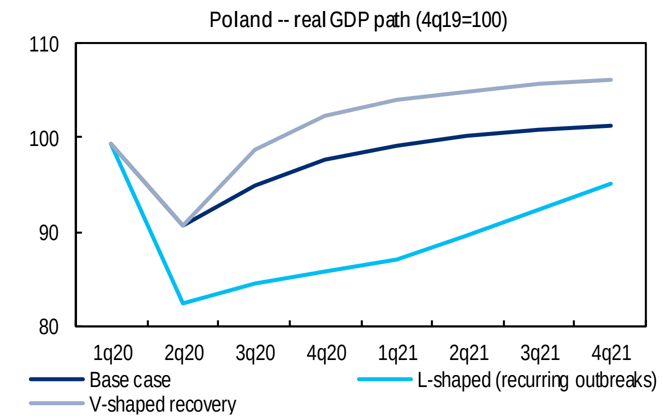


Source: TomTom, Citi Research calculation as of 27 March 2020, 12.55pm

With this in mind we revise our growth forecasts and we now expect the Polish economy to *contract* by ~3.2% in 2020 versus 4.1% growth in 2019. This would be a significantly worse outcome than during the Global Financial Crisis, when Poland *expanded* by 2.6%. The key reason is that this time large part of the economy remains in the lockdown and therefore the FX rate, unlike in 2009, cannot work as a stabilizing force. Assuming that the lockdown will remain in place throughout May, our rough estimates suggest that private consumption could fall by ~10% QoQ in 2Q, with risks skewed to the downside. We expect private sector to cut investment plans sharply, which should be particularly visible in spending on machines and transport equipment. Taking into account the uncertainty regarding future growth outlook we assume ~25% drop in investment in 2Q, though an even deeper contraction appears possible.

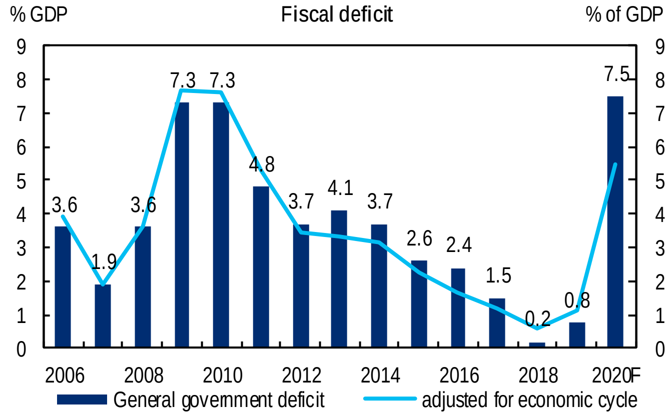
The key question, however, is at what pace the economy can recover in the following quarters. The pace of rebound will depend on whether COVID-19 epidemic will pass in 2H20 or whether it will become a recurring threat, at least until the vaccine is made available. Figure 5 shows potential alternative scenarios. Our base case assumes that lockdowns are gradually removed starting from June and the activity gradually recovers while real GDP returns to 4Q19 levels by mid-2021. The negative scenario is L-shaped and assumes that not only the scale of the 2Q shock is larger, but also the following recovery is substantially slower than in the baseline. As the Figure 5 suggests, we think the balance of risks is asymmetric and potential downward surprises can be potentially bigger than upward surprises.

Figure 5. In the base case we assume real GDP will return to 2019 levels in mid-2021



Source: Citi Handlowy Research estimates

Figure 6. Taking into account the depth of recession, we expect general government deficit to reach ~7.5% of GDP in 2020



Source: Eurostat, Citi Handlowy Research estimates

The labour market will be heavily affected by the recession. In the coming months the number of new unemployed persons will likely rise sharply as firms facing liquidity problems and a drop in demand will try to reduce costs. The extent of layoffs will depend on the length of lockdown but also on the extent of fiscal support for the corporate sector. According to a survey by business organization Lewiatan 69% of Polish firms are planning to reduce employment over next two months and 54% are planning to cut staff by 20-50%. The situation is worse among small sized companies which suggests that the impact on overall employment level may be somewhat smaller than those declarations suggest but it will still be significant. Our base case assumes that the number of registered unemployed will rise on average by ~200 thousand persons per month in May-July period and by the end of the year the cumulative increase will reach 950 thous. (increase vs. December 2019). In the baseline scenario the end-of-year registered unemployment rate is likely to reach 10.9%, thus doubling from the December 2019 level.

The severity of economic shock highlights the need for a large and decisive economic policy stimulus. On March 18th the government revealed a 6% of GDP fiscal package, roughly half of which consists of guarantees. We think this package will probably be increased in the coming months in response to the deterioration in economic activity (a possibility of changes was indeed signaled by authors of the fiscal package). Yet it is important to emphasize that the fiscal response is unlikely to stop the sharp contraction in GDP in 2Q as the recession will be due to the lockdown and social distancing measures. Higher fiscal envelope will not change anything in this respect. Instead, the size and the structure of the fiscal package as well as the speed at which it is going to be delivered will influence chances of companies to survive the extremely weak 2Q and their ability to return to economic life after the restrictions are removed. Taking into account our new GDP forecasts, the shortfall in revenues due to the recession[1] and the likely substantial deterioration in tax collection, we estimate the fiscal deficit may reach ~7.5-8% of GDP in 2020 while public debt could exceed 50% of GDP. If the fiscal package is upgraded the impact on deficit could be even bigger. This also means that our previous estimates of gross borrowing requirement (GBR) rising by as much PLN 110 bn (4.8% of GDP) to PLN 250bn may be too conservative.

We expect also that the central bank will continue to ease monetary policy. Although at this stage there seems to be no agreement within the MPC regarding further rate cuts, we think the incoming weak data will convince MPC members that additional monetary stimulus is necessary. Having said that we think the base rate will be reduced by additional 50bps to 0.5% in 2Q. The central bank will probably continue to organize regular repo operations and will continue asset purchases. The aim of those steps will not be to boost spending (after all, this would not work during lockdowns) but rather to ensure proper functioning of the market and creating space for the fiscal stimulus announced by the government. As far as the FX depreciation is concerned so far the NBP has been silent, sending no signals of possible interventions. However, in the past the willingness of the central bank to step into the FX market depended on the pace of depreciation rather than on the level of EUR/PLN. Therefore if the PLN move accelerates the NBP could use some of its EUR 116bn of reserves to limit currency volatility and possibly slow the depreciation.

Figure 7. Poland – selected macroeconomic forecasts.

	2019	2020F	2021F
GDP growth	4.1	-3.2	4.7
Private consumption	3.9	-4.1	5.4
Fixed investment	6.9	-15.3	5.4
CPI (eop)	3.4	2.4	2.3
NBP reference rate (eop)	1.5	0.5	0.5
General government deficit (% of GDP)	0.8	7.5	5.2
Public debt (% of GDP)	44.3	52.1	53.0

Source: Citi Handlowy research, GUS, NBP, Eurostat

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[1] Assuming 40% sensitivity of the budget to cyclical developments.

Economics Research

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